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Money Laundering bulletin

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Money laundering scale & prevention: facts & myths

*Regulatory authorities justify their anti-money laundering legislative zeal on the basis that they believe money laundering to be on a scale so vast as to threaten the very foundations of the financial system. Think of the IMF's estimate of 2–5% of global GDP or the UK Government's estimate of UK£25 billion. What is interesting, however, writes **Dr Jackie Harvey** of Newcastle Business School, is that as long ago as 1997 and following several years of attempting to measure the volume of laundered funds, the Financial Action Task Force (FATF) simply gave up, noting that "the vast majority of FATF members lack sufficient data to support any credible estimate" (FATF, 1997 page3).*

We are faced with the problem that there has been little work to develop an objective academic analysis of the true extent of laundering, which means that we do not have a framework within which the appropriateness of legislative measures can be evaluated. Without this, it is difficult to challenge the 'alarmist' position of the authorities whereby such estimates have been put forward, quoted and repeated, becoming, through such repetition, seemingly established truths. It can be argued, therefore, that global estimates are little more than informed guesses: "… large numbers are frequently thrown around without serious support" (Reuter and Truman, 2005, p. 56), re-produced to the point at which they gain, through mere repetition, some form of reliable accuracy (see also Levi and Reuter, 2006, p. 327).

Money laundering – imagery

It seems that the bigger the figure for money laundering the more likely it is to be quoted. Indeed, there is even a tendency to 'talk up' the figures as smaller estimates would not only invalidate the logic of the approach but would possibly deter the levels of investment necessary for its operational impact. Without facts, legislation has been based on rhetoric, driven by ill-guided activism responding to the need to be "seen to be doing something" rather than by an objective understanding of its impact on predicate crime. This social panic approach is justified by the language used – we talk of the battle against terrorism or the war on drugs, indicating such skirmishes to be winnable through a reduction in money laundering. Alldridge (2003) makes an interesting observation in this context as to the extent that they are not, we could be facing what he terms 'an exercise in futility' (p.17). However this comes at a cost and for each addition to the legislative armoury, the UK financial sector risks competitive disadvantage.

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The relentless expansion of legislation

The recent and continued expansion of legislation contains no real analysis of the costs and benefits or of its effectiveness but sheer hope that such a blanket approach will in some way prove effective. Over the period from 1990, when the Joint Money Laundering Steering Group (JMLSG) produced its first Guidance Notes, up until the introduction of the 2007 Money Laundering Regulations there have been 14 regulatory and legislative changes. Frequently, the "criminals-are-always-ahead-of-us" argument is used by law enforcement agencies to secure further resources and by government as justification for continuing to widen the definition.

We are now in a position where so much has been committed to this particular approach that it becomes difficult to consider alternative structures for dealing with money laundering, betraying something of a "sunk cost bias" towards the *status quo*. One respondent to some earlier work noted that they did not wish to draw attention to the amounts being spent on compliance as this would "*result in a small revolt internally*". Whilst another noted that: "*spending on compliance is now like an escalator – constantly going up*". As such, the machinery of compliance becomes self generating, clearly no financial institution wants to be told that the millions spent on AML compliance is not money well spent.

Whilst it is perfectly in order for the authorities to anticipate and pre-empt criminal action that might have a detrimental impact on society, there is still the overarching requirement for prudence and appropriate and careful balancing of costs against benefits.

The effectiveness of countermeasures

Conscious of their inability to prove effectiveness and anxious to provide evidence of value for money the UK authorities have increasingly turned to second best performance indicators (an approach suggested by the FATF in 2001): the volume of Suspicious Activity Reports (SARs); numbers of prosecutions and convictions; and, finally, at asset recovery. In so doing, they have inadvertently promoted what can be described as a second best legitimacy seeking approach focused on compliance with systems and procedures – rather than on reducing money laundering and associated predicate crime. We seem to have established what I refer to as the "tick-box" culture. This is not to criticise but to observe – it is an inevitable result of our desire to quantify the unquantifiable.

The FATF also attempted to consider effectiveness by looking at a 'crime rate indicator', which was intended to provide a 'rough guide to the number of drug and fraud offences occurring per head of population' to be used as a proxy for attempts to launder money. The expectation being that this might be expected to fall if legislation is effective. While such a positive approach lends itself to quantification, by definition it fails to consider any non-quantifiable impact such as the regulatory burden of inefficient legislation.

It is reasonable to anticipate a positive correlation between disclosures and prosecutions; however, it might be more relevant to look at the conversion rate of prosecutions into convictions as an indicator of the quality of evidence (assuming that the prosecutions arise as a result of the SAR system). Over the period from 1992 to 2005 (Table 1) the conversion rate has fallen. Further, looking at the sentencing outcomes of those who are convicted, only a third received custodial sentences and these were of relatively short duration (Table 2). This appears to lend to support to the observation of Reuter and Truman (2005) in relation to conviction rates in the US, *"most launderers face a low risk of getting caught"* (p. 59).

In respect of the crime indicator rate identified by the FATF: the number of fraud and drug offences per 1000 head of population stood at 7.1 in 1998/9, peaked at 8.0 in 2002/3 and in 2005/6 stood at 6.83. One is

Table 1: Effectiveness

	1992	2005
Total SARs	11,289	195,702
ML Prosecutions	11	1327
ML Convictions	8	595
Conversion Rate	72.7%	44.8%
Prosecutions % SAR	0.10%	0.68%
Convictions % SAR	0.07%	0.30%
Crime Rate Indicator (per 1000)	6.75	6.83

Table 2: Outcome of conviction for money laundering offences 2005

	2005 (number)	2005 (%)
Total Convicted	595	
Of whom 'sentenced'	575	100%
Conditional Discharge	54	9.4%
Fined	53	9.2%
Community Sentence	240	41.7%
Suspended Sentence	29	5.0%
Immediate Custody*	194	33.7%
Otherwise Dealt With	5	0.9%
*Average sentence length	25.7 months	

inclined to agree with van Duyne (1998), who states that '*it is business as usual*' (p. 370).

Issues of dual standards

The emphasis on the increased number of SARs had been quietly set aside as it became evident that the geometric rise in numbers merely reflected the extension of legislation rather than resulting from more vigilant and effective compliance activity. It also reflects companies attempting to demonstrate compliance with the regulations to avoid accusation of 'failure to disclose'. More worrying is the tendency of firms to see reporting as absolving them of their responsibility, reporting everything that might appear merely unusual in order to achieve the regulatory equivalent of 'covering their backs'. Such that we have the ludicrous situation of banks using the number of SARs submitted to the regulators as an internal measure of performance. Or indeed of one bank being told that for their size they were failing to submit a sufficient number of reports. This suggests that banks are going through the procedures as evidence of compliance rather than in the expectation of unearthing criminal activity.

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The most recent UK mutual evaluation report (FATF 2007) draws attention to the fact that over the period from 30 November 2001, the FSA's Enforcement Division has dealt with 18 cases, of which 14 resulted in enforcement actions, specifically related to anti-money laundering compliance. It is interesting, however, that the comment made is that "*Having regard to the size of the UK's financial sector, the number of FSA disciplinary sanctions (since 2001) seems relatively low.*" Curiously, rather than congratulating the UK on the effectiveness of preventative action and by definition strong compliance (somewhat hard to measure), it is being criticised for not sanctioning more. Is this really risk based of or evidence of of dual standards?

Focus on asset recovery

Increasingly, policy on asset recovery appears to be based on fiscal targets and not set by reference to the numbers of criminals, to crimes committed, or indeed to the desire to reduce crime. Targets for recovery by law enforcement agencies have been set at UK£250m by 2009-10 with, more significantly, a longer term goal of up to UK£1 billion. Of concern is the absence of proof that such sums actually exist to be recovered. Moreover, these estimates appear to be based on somewhat naïve and extremely unsophisticated extrapolation. The Treasury took a sample of the SARs reported last year, these indicated a median value of UK£10,000 and a mean of UK£35,000 for each one. Estimating that 40% were genuinely suspicious, they arrived (40% of 35,000 * 200,000) at an assumption of UK£2-3 billion of laundered money available for recovery.

Analysis of the Home Office joint asset recovery database (JARD) indicates that the vast majority of payments are for relatively small amounts and it is believed these reflect multiple payments against the same case number, particularly in respect of cases involving drugs. (A recovery order against a small time drug dealer might, for example, require them to pay the amount by multiple small monthly payments over a period of years.) There are relatively few large scale payments being made. It is interesting to note that the largest payment size is in the region of UK£1 million whilst, significantly, the average payment size ranges from UK£7,000 to UK£14,000. Median amounts are significantly smaller being in the region of UK£300 to UK£500.

Further analysis was conducted of the 162 cases held on the Assets Recovery Agency database that had been specifically compiled for an intelligence assessment report in 2004. Only 20% of these involved sums in excess of UK£1 million, while 40% involved amounts less than UK£0.5 million. The most seized asset was UK property. Other high value goods were largely vehicles with some holdings of paintings, land and jewellery. Curiously, the amount held in financial assets (including bank accounts) formed a relatively small proportion. These assets primarily comprised tax exempt savings and investments, insurance policies, endowments and pension plans with one or two small holdings of shares. It is doubtful that these small amounts would have the capability of affecting the integrity of the financial system.

So what has been achieved?

- As the focus has always been in terms of the overall quantity of laundering little thought has been given to the development of a clear operational definition of money laundering and this has resulted in an absence of theoretical rigour underpinning empirical work.

- It is impossible to measure the impact of the AML regime simply because we do not know how much would have occurred in its absence.
- What we have is evidence of discrepancy within government databases and record keeping, which brings into question the integrity of data. There is no checking within law enforcement agencies, the Home Office or within the Assets Recovery Agency over either the validity of estimates or of the extent to which estimates and actual remittances are matched. It would appear that there are real data gaps. Critically, it is not possible to be truly certain that the funds were really being laundered rather than simply held by criminals until spent.
- So rather than asking ourselves how well it works (Levi and Reuter, 2006, p. 365 and Reuter and Truman, 2005, p. 56), let us more appropriately ask "does it make any difference?" The constantly widening scope of what constitutes money laundering confuses what is actually being counted and by definition precisely what it is we are trying to measure and, by use of legislation, control.
- Indeed, with over a decade of AML should we not have achieved some sort of reduction in money laundering or is it more convenient to simply suggest that such activity continues unabated?
- The 'threat rhetoric' in which anti-money laundering legislation is required for, and driven by the need to preserve the reputation of the financial sector lacks foundation.
- Evidence indicates that those who are being caught and processed through the criminal and civil courts are far from being sophisticated criminals moving vast sums of money into the financial system and compromising its integrity. In contrast, our criminals demonstrate little investment acumen, being concerned more with the acquisition of physical status enhancing assets.
- Legislation must be based on a clear demonstration of its impact on underlying crime not on ill-guided activism. If the regulatory bodies really do wish to operate a risk based model of compliance then let us have a free and open debate to establish the proper magnitude of such risk.

A final thought

Regulation creates externalities and a sub-optimal solution. In the event there is no clear association between compliance and reduction in money laundering, it might be argued that a welfare superior solution to excessive or inappropriate legislation might be removal of government intervention and subsequent regulation by the free market. Indeed, as noted by Alldridge, would the entire banking system collapse through failure to regulate against laundering? (2003, p. 39).

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